What a Forensic Accountant can do for you.
The Firm

• Founded in Chicago in 2003 by:
  – Craig L. Greene, CPA/CFF, CFE
  – James L. McGovern, CPA/CFF, CVA
  – Jonathan D. Bobb, CPA

• Offices in:
  – Las Vegas, NV
  – Chicago, IL
  – Atlanta, GA (coming soon)

• Specializes in providing expert witness, forensic accounting, fraud examination, asset recovery and forensic computer services to attorneys and organizations.
Expert Witness Services

- Expert witness reports and testimony.
- Expert consulting on legal strategies surrounding accounting issues.
  - Subpoena language
  - Deposition questions
  - “What if” scenarios
  - Assessment of case strengths and weaknesses in subject area
Forensic Accounting Areas

- Fraudulent Misrepresentations in Business Transactions
- Shareholder / Partner Disputes
- Internal Investigations/Embezzlements
- Economic Damage Analysis
- CPA Malpractice
- Financial Statement Fraud
- Bankruptcy / Receivership
- Insurance Fraud
- Estate Investigations
- Asset Identification & Recovery
- Intellectual Property Infringement
- Business Valuations
Forensic Accounting Tools

- Data Mining
- Computer Forensics
- Recreating Financial Records
- Financial Statement Analysis
- Tax Return Analysis
- Following the Cash
- Piercing the Corporate Veil / Alter-Ego Cases
- Background Investigations
- Interviews
Recent Matters

• Fraud in the Inducement case in NV resulting in $85M in damages awarded to client.
• Investigation of parking garage contract identified $3M in unshared profits.
• Investigation of co-packaging agreement identified over $1M in overcharges in one year.
• Analysis of CPA Malpractice suit allowed client to settle $2M claim for only $50K.
When to Call a Forensic Accountant

• Right away!
• Whenever you need to analyze financial records.
• When assets are in question.
• When deposing a financial / accounting individual.
• When economic damages are at issue.
• When tax returns are at issue.
• When your client is afraid an employee has been stealing from them.
Fraud in the Workplace

Fraud Statistics & Facts:
2010 ACFE Report to the Nations

- Organizations lose approximately 5% of their annual revenues to employee fraud, waste and abuse.
- $2.9 Trillion in fraud losses globally.
- The median loss in this study was $160,000.
- Frauds lasted a median of 18 months before being detected.
Most common fraud is asset misappropriation.

More than 85% of fraudsters in the study had never been previously charged or convicted for fraud-related offenses.

Small organizations are disproportionately victimized by occupational fraud – likely due to their less extensive anti-fraud measures.
2010 ACFE Report to the Nations

• More than 80% of frauds in the study were committed by individuals in one of six departments.

➢ Accounting
➢ Operations
➢ Sales

➢ Executive/upper management
➢ Customer service
➢ Purchasing
Occupational Frauds by Category - Frequency

Type of Fraud

- Financial Statement Fraud
  - 2008 Report: 10.3%
  - 2010 Report: 4.8%

- Corruption
  - 2008 Report: 26.9%
  - 2010 Report: 32.8%

- Asset Misappropriation
  - 2008 Report: 88.7%
  - 2010 Report: 86.3%

ACFE Report to the Nations 2010
Occupational Frauds by Category - Median Loss (in $000s)

- **Financial Statement Fraud**
  - 2008 Report: $150
  - 2010 Report: $135

- **Corruption**
  - 2008 Report: $375
  - 2010 Report: $250

- **Asset Missappropriation**
  - 2008 Report: $2,000
  - 2010 Report: $4,100

ACFE Report to the Nations 2010
WHO COMMITS FRAUD?
What Sort of Person Commits Fraud?

- Someone with a shifty appearance?
- In need of a shave & haircut?
- Black shirt, white tie?
- Sneering glare?
- Low cut blouse, too much makeup, big hair?
- Fraud perpetrators tend to be the least suspected.
Perpetrators

• More authority = greater access to resources & ability to override controls.
• More trust = autonomy & authority…and opportunity.
• More frauds are committed by employees and managers than owners/executives.
• The size of the losses increases directly with authority of the perpetrator’s position.
Perpetrators

Owner/Executive Fraud:
$834,000 median loss

3x Manager Fraud:
$150,000 median loss

9x Employee Fraud:
$70,000 median loss
Perpetrators

- Frauds committed by higher level perpetrators also took longer to detect:

**Months to Detection Based on Position**

<table>
<thead>
<tr>
<th>Position</th>
<th>Median Months to Detect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner/ Executive</td>
<td>24</td>
</tr>
<tr>
<td>Manager</td>
<td>18</td>
</tr>
<tr>
<td>Employee</td>
<td>13</td>
</tr>
</tbody>
</table>

Median Months to Detect
Perpetrators

• Tenure of perpetrator has no strong correlation
  – 49% was with the Victim Co. < 5 Years
  – 51% was with the Victim Co. > 5 Years

• Only 7% of fraud perpetrators had been previously convicted of a fraud-related offense.
Perpetrators

• 57% of frauds in the U.S. were committed by males.

• The median loss caused by male perpetrators ($167,000) was more than twice as much as the median loss caused by female perpetrators ($82,000).
Perpetrators

• Age Factors:
  – More than 1/2 of frauds are committed by individuals over 40.
  – 1/3 of frauds are committed by individuals between 41-50.
**Perpetrators**

- **Educational Levels:**
  - 14% had post-graduate education.
  - More than 50% attended or graduated from college.
  - 39% were high school graduates with no college.

- The higher the education, the higher the loss:
  - High School $100K
  - Some College $136K
  - College Degree $234K
  - Post-graduate $300K
# Perpetrators

<table>
<thead>
<tr>
<th>Department</th>
<th>Percent of Cases</th>
<th>Most Likely Fraud Scheme</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting</td>
<td>24.3%</td>
<td>Check tampering*</td>
</tr>
<tr>
<td>Operations</td>
<td>20.7%</td>
<td>Corruption</td>
</tr>
<tr>
<td>Executive/Upper Management</td>
<td>13.9%</td>
<td>Corruption</td>
</tr>
<tr>
<td>Sales</td>
<td>13.1%</td>
<td>Corruption</td>
</tr>
<tr>
<td>Customer Service</td>
<td>8.4%</td>
<td>Corruption</td>
</tr>
<tr>
<td>Internal Audit</td>
<td>0.2%</td>
<td>Corruption</td>
</tr>
</tbody>
</table>

*In Accounting, Corruption was 8th at only 10.4% versus Check Tampering at 33.2% of cases.*
Perpetrators

- Living beyond their apparent means – 45% of the cases.
- Experiencing financial difficulties at the time of the fraud – 45%.
WHY DO THEY DO IT?
Cressey’s Hypothesis: The Fraud Triangle

Non-sharable Financial Problem

Rationalization  Opportunity
Non-Sharable Financial Problem

- Violation of ascribed obligations
- Problems resulting from personal failure
- Business reversals
- Physical isolation
- Status-gaining
- Employer-employee relations
Rationalization

• A "non-sharable" financial problem must exist.
• Individuals and groups must have knowledge necessary to commit the embezzlement.
• Suitable rationalizations for such behaviors must be available to perpetrators.
Rationalization

• “I’m only borrowing this money; I’ll pay it back.”
• “I’m not really hurting anyone.”
• “Everyone is a little dishonest.”
• “It’s for a good purpose.”
• “It’s not that serious.”
• “It’s too easy. It’s like they’re daring me.”
• “Everyone does it.”
Opportunity

• The opportunity to commit and conceal the fraud is the only element over which the employer has significant control.

• Many believe that if one of the three legs of the triangle is taken away, fraud will not be committed.
The Fraud Scale

- **Situational Pressures**
  - High
  - Low

- **Opportunities to Commit**
  - High
  - Low

- **Personal Integrity**
  - Low
  - High

The center of the diagram represents high fraud, with low fraud at the sides.
What to Look For?

• Unexplainable wealth
• Refusal to take promotions
• Refusal to take time off
• Unusual hours and/or taking on additional work
• Doing jobs below their position or taking on others’ responsibilities
• Addictive behaviors – alcohol, drugs, gambling
HOW DO THEY DO IT?
A red flag is an indicator that something may be wrong and should not be ignored.

However, sometimes an error is just an error.

SAS 82: Consideration of Fraud in a Financial Statement Audit.
Cash Frauds

Incoming Cash Frauds

• Skimming
• Substituting personal checks for cash
• Altered receipts

Fraudulent Disbursements

• Fictitious refunds & discounts
• Check tampering
• Falsified expense reports
• Payroll fraud
Red Flags for Cash

Incoming Cash Fraud Flags

• Sales volume drops unexpectedly.
• Customer claims that A/R balances have been paid.
• Employee makes extra effort to be the person to handle/make deposits.
• Lower average cash volume.

Disbursement Fraud Flags

• Entity with the same initials (and address) as a payables employee.
• New vendor at higher price.
• Unusual payroll tax withholding.
• Expense support is printout of order prior to actual placement.
A/R Fraud

- Lapping
- Posting improper credits
- Altering internal copies of invoices
- Unjustified credit being offered
- Fictitious refunds
A/R Red Flags

- Examples of red flags in A/R include:
  - Excessive number of voids, discounts and returns
  - Unauthorized bank account in a company name
  - Sudden activity in a dormant banking account
  - Customer receiving notices for non-payment on account
  - Discrepancies between bank deposits and posting to the account
  - Large number of write-offs of accounts
Purchasing & Procurement Fraud

- Forming fictitious vendors
- Pass-through schemes
- Submitting false invoices
- Self-approval of fraudulent invoices
- “Rubber Stamp” supervisor approval
- Double-paying invoices
- Personal purchases through company
Examples of Red Flags in Ghost Vendors include:
- Lack of physical addresses in the vendor set-up files
- Multiple companies that have the same address and phone number
- Invoiced goods/services cannot be located/verified
- Sequentially numbered invoices
- Photocopied invoices or invoices that have been tampered
- Increase in purchasing inventory but no increase in sales
Corruption Schemes

- Bribery
- Illegal Gratuity
- Commercial Bribery
- Conflict of Interest
Red Flags of Corruption Schemes

• Purchasing agent handles all matters related to a vendor even though it might be outside or below his normal duties
• Vendors who receive an inordinate amount of business for no apparent business reason
• Vendor salesmen make frequent, unexplained visits to purchasing personnel
• Prices from a particular vendor are unreasonably high when compared to others
• Purchase of excess goods
Vendor Fraud
What to Look For?

- Fictitious Companies
- Quality of Goods
- Accuracy of Shipments
- Appropriate Pricing
- Corruption Schemes
Fraud Schemes

Classification:

◆ Shell Company Schemes
◆ Vendor Overcharges and/or Material Substitution Schemes
◆ Employee Corruption Schemes
Shell Company Scheme: How it Works

- The fraudster forms the Shell using another person’s name as the owner (“straw man”).
- Typically, the fraudster is in a position to:
  - Authorize the purchase of goods and/or services
  - Approve payment of the goods and/or services
  - Supervise employees who authorize and/or pay for the goods and services
Forming a Shell Company

- Articles of incorporation
- “Assumed name act” (or D/B/A) certificate
- Partnership agreement
Ways Fraudsters Avoid Detection

- Use another person’s name as owner (straw man)
- Use postal boxes and mail drop
- Use their home address
Submitting False Invoices

- Create the invoice using a professional printer, computer or even a typewriter
- Bill employer
- Submit invoice for payment
- Examiner should thoroughly examine the invoice
Investigating the Shell

- Investigate the background of the company and its principals using public records and online tools.
- Perform forensic accounting analyses of accounting and other documents.
- Perform an on-site audit of books and records.
Researching the Shell’s Background

Obtain copies of the following:

- Articles of Incorporation or D/B/A filing
- All annual reports
- Dun & Bradstreet full business report
Researching the Shell’s Background

- Search public records, including litigation filings
- Search the Internet and other relevant business information sources
- Examine shipping documents to determine source of goods purchased
Researching the Shell’s Background

Obtain the fair market value for the goods & services purchased from the suspected Shell

- make a pretense call to the identified supplier
- call other competitors of the suspected Shell
Analyzing the Shell’s Financial Transactions

Obtain the following internal documents:

– History of payments
– Purchase orders sent to suspected Shell
– Purchase order requisitions
– Receiving documents
– Other internal files
Analyzing the Shell’s Financial Transactions

Analyze the invoices to determine the following:

- Total payments to suspected Shell for each year
- If duplicate payments were made
- If a sequential numbering pattern exists
Analyzing the Shell’s Financial Transactions

“Audit” procedures which should be performed:

- Compare quantities received and pricing to applicable purchase order(s)
- Recalculate the billing amounts and math as shown on the invoices
- Determine the individuals who requisitioned the items and completed the purchase orders
- Examine other files for relevant information
Analyze the Shell’s Financial Transactions

Prepare an estimate of damages

– Compare the fair market value previously established to the actual amount paid

– Determine an estimate of damages
Focus of Vendor On-Site Audit

- To find the payments to the employee or the employee’s Shell
- To examine any cash distributions, cash withdrawals, or wire transfers which may be the source of the corruption payments
- Ensure employer checks were not cashed or laundered through an offshore account
Focus of Vendor On-Site Audit

To review the cash disbursements of the vendor, identifying:

- Any payments to employees
- Any payments to employee controlled entities
- Excessive owner distributions
- Other unusual transactions
Focus of Vendor On-Site Audit

- Ascertain the gross profit of the company on sales made to the employer
- Examine Form 1099 for any payments to employees or employee controlled entities
- Examine employee expense reports
Focus of Vendor On-Site Audit

- Determine the “true” ownership of the suspected Shell
- Perform a detailed investigative interview
Vendor Overcharges and/or Material Substitution Schemes

Examples:

– Overcharging for Professional Hours
– Overcharging for Contractor Labor and Materials Used
– Material Substitution and Freight Over-billing Scheme
Overcharging for Professional Hours

Red Flags:

♣ Billing separate divisions resulting in a total time charge which exceeds 24 hours per day
♣ Consistently exceeding an 8 hour workday
♣ Working on holidays
Overcharging for Contractor Labor & Materials Used

Examples:

- Charging for employees not present at job site
- Charging journeyman rates for apprentices
  - Charging more than 24 hrs/day for the same foreman
  - Charging for more materials than actually used
Material Substitution & Freight Over-billing Scheme

- Billing for higher quality materials when those of a lesser quality were actually shipped
- Falsifying the source location in order to inflate shipping costs
Investigating Vendor Overcharges and/or Material Substitution

- Perform a detailed litigation search for other lawsuits against vendor
- Focus on individual transactions and actual receipt of goods or services
- Most importantly, conduct a vendor on-site audit
Employee Corruption Schemes

Types:

- Bribery
- Commercial Bribery
- Economic Extortion
Corruption Scheme: How it Works

- Inflating the selling price to the employer to include the corrupt payment
- Shipping lesser quality goods or services to reduce the operating cost to provide for the corrupt payment
- Deviating from the specifications of the items or services purchased
Investigating a Corruption Scheme

- Conduct a background investigation of the employee, the suspected corrupt payer, and its principals
- Prepare a personal and financial profile including a net worth analysis of the employee
The Accounting Analysis of Corruption Schemes

- Determine the need of the items purchased
- Audit the activities before purchasing actions
- Determine if contract specifications were met
- Scrutinize solicitations for bids, proposals, and quotations
The Accounting Analysis of Corruption Schemes

- Maintain security of bids before and after opening
- Ensure that vendor is qualified to receive award
- Ensure the integrity of award procedures
The Accounting Analysis of Corruption Schemes

- Monitor vendors’ production process
- Monitor quality assurance
- Search for waivers granted
- Search for any collusion in the bidding
- Be alert to “buying in”
CASE STORY – ILLUSTRATE THE POINTS
Ben The Tax Accountant

• Ben was a tax accountant for a subsidiary of a $7 billion corporation.

• Ben had been with the company for over 28 years – holding the same position after his first 18 months with the company.

• One day the company’s General Manager received a call from the fraud unit of the company’s bank.
**Discovery**

- The fraud unit representative told the General Manager that over the past several months the unit had been tracking some unusual deposit activity.

- Company checks payable to the bank in the amount of $7,500 were being deposited into an account in the name of Emily’s Boutique Store.
Discovery

• The General Manager knew that Emily was, in fact, Ben’s wife.

• He then proceeded to call Ben to his office, wherein he accused Ben of theft of company funds.

• During the interrogation the General Manager discovered customer checks in Ben’s briefcase.
Discovery

• The company found that checks allegedly used to pay a Diesel Fuel Tax were being diverted to Ben.

• An examination of the transactions revealed that the company’s checks had been previously deposited into the company’s C.O.D. Account.
# Ben’s Scheme

<table>
<thead>
<tr>
<th>As Prepared by Accounting</th>
<th>Change</th>
<th>As Prepared by Ben</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 2,874.00</td>
<td>$(2,800.00)</td>
</tr>
<tr>
<td>CLG Const.</td>
<td>3,200.00</td>
<td>(3,200.00)</td>
</tr>
<tr>
<td>B&amp;M Concrete</td>
<td>1,000.00</td>
<td>(1,000.00)</td>
</tr>
<tr>
<td>Woods Contractors</td>
<td>4,650.00</td>
<td></td>
</tr>
<tr>
<td>US Construction</td>
<td>500.00</td>
<td>(500.00)</td>
</tr>
<tr>
<td>James Builders</td>
<td>2,750.00</td>
<td></td>
</tr>
<tr>
<td>Kyle’s Konkrete</td>
<td>1,380.00</td>
<td></td>
</tr>
<tr>
<td><strong>Company Check</strong></td>
<td><strong>7,500.00</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$16,354.00</strong></td>
<td></td>
</tr>
</tbody>
</table>
Profile of Ben

• Unexplained wealth.
• Very few days taken off for sick or vacation time.
• Refusal to take a promotion.
• Unusual hours.
• Unusual story explaining his circumstances.
Fraudulent Financial Statements
FRAUDULENT FINANCIAL STATEMENTS

- Overstate assets or revenues
- Understate liabilities or expenses
Reasons for Fraudulent Financial Statements

- Increase the apparent prosperity of the organization
- Meet performance goals
Types of Fraud

- Fictitious Revenues
- Timing Differences
- Concealed Liabilities and Expenses
- Improper Disclosure
- Improper Asset Valuation
FICTITIOUS REVENUES

• Involves the sale or goods or services which never occurred
  – Purpose is to overstate or inflate the sales figures to make the business appear more profitable
  – Usually involves the manipulation of invoices
  – Fake or legitimate customers
TIMING DIFFERENCES

• Revenue should be recognized in the accounting records when the sale is complete.

• In service business, revenue is recognized when the service has been rendered.
TIMING DIFFERENCES

- Improper matching of revenues
- Early revenue recognition
- Recording expenses in the wrong period
CONCEALED LIABILITIES

• Understating liabilities causes the equity account to increase in order to balance

• Understating expenses causes net income to be artificially overstated thus increasing the equity account
Methods of Concealing Liabilities

• Liability/expense omissions
• Improper capitalizing/expensing
• Returns and allowances and warranties
**IMPROPER DISCLOSURES**

Financial statements and notes are required to include all information necessary to prevent a user from being misled.
IMPROPER DISCLOSURES

- Related party transactions
- Liability omissions
- Significant events
- Management fraud
- Accounting changes
IMPROPER ASSET VALUATION

- Assets should be recorded at original cost
- Some Assets are valued at lower cost or market
- Assets are not increased to reflect current value
IMPROPER ASSET VALUATION

Inventory

- Valued at the lower cost or market
- Should be written off if it has no current value
- Can be overstated by manipulation of inventory count
IMPROPER ASSET VALUATION

Accounts receivable

• Fictitious receivables
• Failure to write down receivables as bad debts
IMPROPER ASSET VALUATION

Fixed Assets

- Booking fictitious assets
- Misrepresenting value
- Improper capitalizing inventory and start-up costs
Questions?

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